

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #07-35**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Whether the monthly subscription fee for providing certain web-based software and services will be subject to Tennessee sales or use tax.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (G) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER] is a Delaware corporation based in [STATE-NOT TENNESSEE] that provides a comprehensive array of on-demand customer relationship management ("CRM") application services to businesses through an "application service provider" ("ASP") model. CRM services are used by companies to manage their relationships with customers, including the capture, storage and analysis of customer information.

The need for ASPs has evolved from the increasing costs of specialized software that have far exceeded the price range of small to medium sized businesses. In an ASP model, the application software resides on the ASP's system and is accessed by users through the Internet. Users cannot install or transfer the software to their own computers. The ASP fully owns and operates the software applications. In addition, the ASP owns and maintains the servers that support the software.¹ Software offered using an ASP model is sometimes called on-demand software.

Taxpayer provides access to its CRM application services on a subscription basis.² Taxpayer's customers pay a monthly subscription fee to obtain unique user accounts for use by their employees and other authorized users. Customers can access most products by using a standard web browser and a password. Customers are prohibited from modifying, copying or making derivative works of Taxpayer's applications.

Specific Products and Services

Taxpayer's CRM application services support the three key functional areas – sales, customer service/support, and marketing automation.

- Sales Force Automation – Customers use Taxpayer's CRM application service to establish a system and process for recording, tracking, and sharing information about sales opportunities, sales leads, sales forecasts, sales processes, closed businesses and sales territory management.
- Marketing Automation – Customers use Taxpayer's CRM application service to manage marketing campaigns and to determine the effectiveness of each campaign by quantifying the revenue generated as a result of specific marketing activities.
- Customer Service and Support Automation – Customers use Taxpayer's CRM application service to interact more efficiently and professionally with their existing customers for a variety of needs (*e.g.*, requests for repairs, advice about products and services, complaints about faulty goods, needs for additional goods and services).

Taxpayer also provides, upon request, an application programming interface ("API") that customers can use to build and deploy their own custom applications. API is software that provides a set of rules to facilitate exchanging messages or data between two or more different software applications. API is the virtual interface between two inter-working pieces of software, such as a word processor and a spreadsheet. Using the API, customers can customize their existing third-party applications to communicate directly with the CRM application on Taxpayer's servers. Taxpayer currently does not charge for the use of the API. No software other than the API software is downloaded by the customer.

QUESTIONS

¹ Taxpayer's systems are currently hosted on servers located in [STATE-NOT TENNESSEE] and [STATE-NOT TENNESSEE]. Taxpayer has paid sales tax on the purchase or lease of these servers.

² Taxpayer sends invoices for the monthly fees to each customer's headquarters location; however, the employees or other authorized users accessing the service may be located in various states or foreign countries.

1. Is the monthly subscription fee subject to Tennessee sales or use tax?
2. Is the monthly subscription fee subject to Tennessee sales tax under the provisions enacted in Tennessee to bring the state into compliance with the Streamlined Sales and Use Tax Agreement (the “Agreement”)?

RULINGS

1. No. The monthly subscription fee is not subject to Tennessee sales or use tax.
2. No. The monthly subscription fee is not subject to Tennessee sales or use tax under the Agreement as adopted by Tennessee.

ANALYSIS

Retail sales in Tennessee are subject to sales and use tax under Tenn. Code Ann. § 67-6-101 *et seq.* Tenn. Code Ann. § 67-6-102(34)(A) defines a “retail sale” to include a “taxable sale of tangible personal property or specifically taxable services to a consumer or to any person for any purpose other than resale.”

The retail sale of customized or packaged computer software, as well as the modification of existing software, is subject to sales and use tax. Tenn. Code Ann. § 67-6-102(36)(B) provides that the term “sale” includes the “transfer of customized or packaged computer software, which is defined to mean information and directions loaded into a computer which dictates different functions to be performed by the computer whether contained on tapes, discs, cards, or other device or material.”³

Additionally, the retail sale of telecommunications services is among the services that are subject to sales and use tax. Tenn. Code Ann. § 67-6-102(34)(F)(iii) provides that retail sales include the “furnishing, for a consideration, of either intrastate, interstate or international telecommunications services.” Tenn. Code Ann. § 67-6-102(46)(A) defines “telecommunications service” in pertinent part as “the electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points.” The term “telecommunications service” includes “such transmission, conveyance, or routing in which computer processing applications are used to act on the form, code or protocol of the content for purposes of transmission, conveyance or routing without regard to whether such service is referred to as voice over Internet protocol services or is classified by the Federal Communications Commission as enhanced or value added.” *Id.*

Tenn. Code Ann. § 67-6-102(46)(B) provides that the term “telecommunications service” does not include “data processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser where

³ As of January 1, 2008, pursuant to Acts 2007 Public Chapter 602 the authority to tax sales or use of computer software will be found in Tenn. Code Ann. § 67-6-231.

such purchaser's primary purpose for the underlying transaction is the processed data or information. . . ."

1. *Taxability of the monthly subscription fee.*

Taxpayer provides access to software contained on its servers over the Internet through an ASP service in exchange for a monthly subscription fee. The monthly subscription fee is not subject to Tennessee sales or use tax.

First, Taxpayer's business qualifies as a non-taxable information service under Tenn. Code Ann. § 67-6-102(46)(B). Retail sales of tangible personal property and specifically taxable services in Tennessee are subject to sales and use tax under Tenn. Code Ann. § 67-6-101 *et seq.* Tenn. Code Ann. § 67-6-102(34)(F)(iii) provides that retail sales include the "furnishing, for a consideration, of either intrastate, interstate or international telecommunications services." The term "telecommunications service" is defined under Tenn. Code Ann. § 67-6-102(46)(A) as "the electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points." While the retail sale of telecommunications services is subject to taxation, Tenn. Code Ann. § 67-6-102(46)(B) provides that the term "telecommunications service" does not include data processing and information services "that allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser where such purchaser's primary purpose for the underlying transaction is the processed data or information."

Taxpayer's business qualifies as a non-taxable information service under Tenn. Code Ann. § 67-6-102(46)(B) because its customers' primary purpose in engaging in the transaction is the acquisition of the processed data or information. Taxpayer sells data processing and information services by charging a fee for customers to access its software. Taxpayer's customers use the CRM application services to record, track and share sales-related information, and manage marketing campaigns by quantifying revenue. Importantly, Taxpayer's customers do not use Taxpayer's CRM application services as a telecommunication service. Rather, the service permits the customer to generate, store, and process data and information. Accordingly, the monthly fee charged by Taxpayer is not taxable as the retail sale of a telecommunications service.

Note that Taxpayer's ASP service would not come within the definition of any other taxable service listed in Tenn. Code Ann. § 67-6-102(34)(F).⁴

Second, Taxpayer is not engaging in the retail sale of software. The retail sale of customized or packaged computer software, as well as the modification of existing software, is subject to sales and use tax. Tenn. Code Ann. § 67-6-102(36)(B) provides that the term "sale" includes the "transfer of customized or packaged computer software, which is defined to mean information and directions loaded into a computer which dictates different functions to be performed by the computer whether contained on tapes, discs, cards, or other device or material."⁵ *See, e.g., University Computing Company v. Olsen*, 677 S.W.2d 445 (Tenn. 1984); *Creasy Systems*

⁴ As of January 1, 2008, pursuant to Acts 2007 Public Chapter 602 the authority to tax certain services will be found in Tenn. Code Ann. § 67-6-205(c).

⁵ As of January 1, 2008, pursuant to Acts 2007 Public Chapter 602 the authority to tax sales or use of computer software will be found in Tenn. Code Ann. § 67-6-231.

Consultants, Inc. v. Olsen, 716 S.W.2d 35 (Tenn. 1986). Computer software is considered tangible personal property pursuant to Tenn. Code Ann. § 67-6-102(36)(B). Additionally, the fabrication of software by a person for such person's own use or consumption is not considered a taxable "use." Tenn. Code Ann. § 67-6-102(36)(B).

Taxpayer provides a service whereby clients are allowed to access Taxpayer's CRM software remotely via the Internet. The CRM software always remains on Taxpayer's servers. The software is never installed on, or transferred to, the clients' computers. Because title and possession of the software always reside with Taxpayer, there is no transfer for purposes of Tenn. Code Ann § 67-6-102(36)(B). Accordingly, the monthly fee for the ASP service to access the CRM software through the Internet is not a taxable sale of software.⁶

Third, no taxable sale of tangible personal property occurs when Taxpayer provides a customer with API software, because the transfer of the API software is incidental to the sale of a nontaxable service. As noted above, the retail sale of customized or packaged computer software, as well as the modification of existing software, is subject to sales and use tax.

The Tennessee Supreme Court has stated that although tangible personal property may be transferred to the customer incidental to the sale of a service, such incidental property does not transform the otherwise nontaxable sale into a taxable sale of tangible personal property. *Commerce Union Bank v. Tidwell*, 583 S.W.2d 405 (Tenn. 1976). More precisely, the Tennessee Supreme Court has held that "when the primary function and purpose of the taxpayer is to provide services, the ownership, use and maintenance of certain types of personal property and equipment are necessary in order to enable it to furnish the services, so that the taxpayer, not its customer, is the ultimate user or consumer within the meaning of sales and use tax statutes." *Nashville Mobilphone Co. v. Woods*, 655 S.W.2d 934, 937 (Tenn. 1983).

While Taxpayer's customers can access the CRM software through a web browser with a password, Taxpayer will provide customers with API software upon request. The API software resides on the customer's computer. Because computer software is considered tangible personal property pursuant to Tenn. Code Ann. § 67-6-102(36)(B), the Taxpayer will be providing its customers with tangible personal property as part of the sale of the ASP service. However, the transfer of computer software is incidental to the sale of nontaxable services, and as such is not taxable. Under the facts presented, Taxpayer's primary function and purpose is to provide the ASP service that allows customers to access the CSM software on Taxpayer's computers. Using the API software, customers can customize their existing third-party applications to communicate directly with the CRM application on Taxpayer's servers. Significantly, the API software simply provides the customer with another means of accessing the nontaxable service. As such, the transfer of the API software is incidental to the sale of the nontaxable service, and does not transform the sale of the service into a taxable sale of tangible personal property.

Note that Taxpayer will owe use tax on the API software that it imports into Tennessee for its subscribers' use, as the Taxpayer is the ultimate user or consumer of the API software. The Tennessee use tax may be offset by any sales or use tax the Taxpayer paid on its purchase of the

⁶ If the ASP fee is combined (bundled) with the sale of tangible personal property or a taxable service, and the charges for the non-taxable services are not separate and optional from the taxable charges, then the sales tax applies to the total package.

API software. However, pursuant to Tenn. Code Ann. § 67-6-102(36)(B), if Taxpayer itself created the API software for its own use, the API software would not be subject to Tennessee use tax when it is imported into Tennessee.

2. *The monthly subscription fee under the Streamlined Sales Tax Agreement as adopted by Tennessee.*

The analysis and conclusions reached above would be the same if the provisions of the Streamlined Sales and Use Tax Agreement as adopted by Tennessee were applied.⁷ The implementation in Tennessee of the provisions of the Streamlined Sales Tax Agreement will not change the taxability of Taxpayer's service. The authority to tax the sale or use of software will be found in Tenn. Code Ann. § 67-6-231 instead of in the definition of "sale" under Tenn. Code Ann. § 67-6-102(36)(B). The definition of "telecommunication services" will remain the same.

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APPROVED: Reagan Farr
Commissioner

DATE: 11/26/07

⁷ As of January 1, 2008, pursuant to Acts 2007 Public Chapter 602, the Streamlined Sales and Use Tax Agreement definitions will become effective in Tennessee. Several accompanying changes to the sales and use tax statutes will become effective on January 1, 2008, as well, in order to accommodate the new definitions. The destination sourcing, single return, and bundled transactions provisions of the Streamlined Sales and Use Tax Agreement and the new Tennessee privilege taxes will become effective on July 1, 2009.